

Message Text

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USOECD

PASS: CEA, TREAS, FRB

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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF GERMANY

REF: (A) EDR(77)14; (B) STATE 126599;
(C) OECD PARIS 15241

1. SUMMARY: PREDICTABLY, GERMANS LEVELED A BARRAGE OF ARGUMENTATION AT JUNE 3 EDRC MEETING IN SUPPORT OF THEIR VIEW THAT EXPANSION BROADLY AT PACE CONSISTENT WITH FRG TARGETS AND WITH WHAT IS INTERNATIONALLY DESIRABLE WILL BE SUSTAINED IN 1977 AND INTO FIRST HALF OF 1978, AND THAT FRG ECONOMIC POLICY SHOULD CONTINUE TO FOCUS ON PRICE MODERATION RATHER THAN NEED TO INDUCE FASTER GROWTH. THEY PROJECTED 1977 GNP GROWTH RATE AT 4.5 PERCENT ON BASIS NEW STATISTICAL SERIES, WHICH THEY ARGUED IS ONLY
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SLIGHTLY BELOW 5 PERCENT TARGET BASED ON PREVIOUS SERIES. MOREOVER, GERMAN DEL (LED BY DICK OF ECONOMICS MINISTRY) REITERATED FAMILIAR ECONOMICS MINISTRY POSITION THAT FISCAL STIMULUS WOULD BE FUTILE (EVEN IF IT APPEARED NECESSARY) IN THAT IT WOULD HAVE COUNTERPRODUCTIVE EFFECT ON GROWTH AND, IN ADDITION, WOULD BE CONTRARY TO FRG'S MEDIUM-TERM OBJECTIVE OF REDUCING BUDGET DEFICIT. NEVER-

THELESS, IN SUPPORT OF THEIR GROWTH FORECASTS, GERMANS CITED SEVERAL GENERAL MEASURES (INCLUDING SOME RELAXATION OF MONETARY POLICY) TAKEN RECENTLY WHICH WOULD HELP UNDERPIN ECONOMIC ACTIVITY. WHILE DENYING EFFICACY OF FISCAL STIMULUS AND UNDERLINING INFLATION CONSTRAINT TO FASTER GROWTH, FRG DELS DID STRESS THAT CURRENT LEVEL OF UNEMPLOYMENT (1 MILLION) WAS POLITICALLY UNSUSTAINABLE; NEVERTHELESS, THEY ARGUED THAT SIGNIFICANT REDUCTION IN UNEMPLOYMENT COULD BE BROUGHT ABOUT IN THE PERIOD TO MID-1978 THROUGH SELECTIVE MANPOWER PROGRAMS. THEY FLATLY REJECTED SECRETARIAT'S SUGGESTION THAT UNEMPLOYMENT/INFLATION TRADEOFF COULD BE IMPROVED IF, UNDER "CONCERTED ACTION PROGRAM," FRG UNDERTOOK COMMITMENT TO EXPAND DEMAND, IN RETURN FOR LABOR AND BUSINESS COMMITMENTS TO RESTRAIN WAGE AND PROFIT INCREASES.

2. NOTING STRONG GERMAN CURRENT ACCOUNT PERFORMANCE IN FIRST QUARTER OF 1977, U.S. WAS SKEPTICAL OF GERMAN AND SECRETARIAT FORECAST THAT SURPLUS WOULD DECLINE TO \$1.5 BILLION IN 1977 FROM \$3.0 BILLION REGISTERED LAST YEAR. SECRETARIAT AGREED THAT ITS FORECAST COULD WELL BE TOO LOW AND IN THIS CONTEXT EMPHASIZED THAT FRG POLICIES SHOULD AIM TO ELIMINATE SURPLUS BY INDUCING GROWTH OF DOMESTIC DEMAND WHICH WOULD EXCEED THAT OF GNP. GERMANS WERE COOL TO THIS AND TO ALL OTHER PROPOSALS WHICH IMPLIED ENHANCED FISCAL STIMULUS; SECRETARIAT INSISTED THAT MORE STIMULUS WAS APPROPRIATE FROM BOTH DOMESTIC AND INTERNATIONAL STANDPOINT. NO AGREEMENT ON DRAFT SURVEY'S POLICY CONCLUSIONS REACHED AT EDRC MEETING. SECRETARIAT LIMITED OFFICIAL USE

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AND FRG WILL HAGGLE BILATERALLY IN SEARCH OF COMPROMISE TO SUBMIT TO EDRC FOR APPROVAL. END SUMMARY

3. (FYI: AS NOTED IN BONN 9091, FRG DEL EXPLAINED THAT ITS FORECAST OF 4.5 PERCENT RISE IN REAL GNP FOR 1977, CITED PARA 4 BELOW, IS BASED ON REVISED NATIONAL ACCOUNTS STATISTICS, INCLUDING REBASED PRICE INDEX; THEY STATED THAT THIS ADJUSTMENT EXPLAINED 0.3 PERCENT OF THE DIFFERENCE BETWEEN NEW PROJECTION AND 1977 GROWTH TARGET OF ABOUT 5 PERCENT BASED ON PREVIOUS STATISTICAL SERIES. ALTHOUGH SECRETARIAT'S FORECASTS USE OLD DATA BASE, SECRETARIAT INDICATED THAT SHIFT TO NEW BASE WOULD LOWER ITS FORECAST BY ONLY 0.1 PERCENT. IN ADDITION, SECRETARIAT AND FRG AGREED THAT CHANGE IN BASE WOULD HAVE NO APPRECIABLE EFFECT ON FORECAST OF INDIVIDUAL DEMAND COMPONENTS. THUS, IN DISCUSSION WHICH FOLLOWS, SECRETARIAT'S AND FRG'S FORECASTS ARE COMPARED DIRECTLY.)

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4. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK FOR 1977:
FRG DEL FORECAST 4.5 PERCENT RISE IN REAL GNP IN 1977
COMPARED WITH SECRETARIAT FORECAST OF 4 PERCENT. THEY
STRESSED THAT STRENGTH OF EXPANSION WAS CONFIRMED AND
SPRUNG ON UNAWARE SECRETARIAT REVISED INDUSTRIAL PRODUCTION
FIGURES FOR FIRST QUARTER OF 1977 (SEE BONN 9121).
THESE FIGURES SHOWED RISE IN INDUSTRIAL PRODUCTION OF 7
PERCENT OVER FIRST QUARTER OF 1976 IN CONTRAST TO 3.7 PERCENT
INCREASE SHOWN IN PRELIMINARY ESTIMATES. GERMANS
ALSO NOTED THAT REVISED DATA SHOWED 5.5 PERCENT RISE IN
NEW ORDERS BETWEEN FEBRUARY AND MARCH THIS YEAR, COMPARED
WITH PREVIOUSLY ESTIMATED INCREASE OF 1-1.5 PERCENT.
WHILE TAKEN BY SURPRISE BY REVISED INDUSTRIAL PRODUCTION
FIGURES, SECRETARIAT RECOVERED QUICKLY AND NOTED THAT
DATA FOR ONE MONTH DID NOT CONSTITUTE A TREND.

5. FRG DEL FORECASTED STRONGER OUTLOOK IN 1977 FOR MOST
DEMAND COMPONENTS THAN SECRETARIAT. THEY ARGUED THAT
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GROWTH OF PRIVATE CONSUMPTION LIKELY TO EXCEED 4 PERCENT PROJECTED BY SECRETARIAT SINCE TOTAL WAGE INCOME EXPECTED TO RISE BY 8.5 PERCENT RATHER THAN BY 7.5 PERCENT AS FORE- SEEN BY SECRETARIAT. GERMANS ADDED THAT 10 PERCENT RISE IN RETAIL SALES VOLUME IN FIRST QUARTER OF THIS YEAR HEIGHTENED CREDIBILITY OF THEIR FORECAST. MOREOVER, FRG FELT THAT CONSUMPTION SPENDING WOULD ACCELERATE DURING 1977 (SECRETARIAT FORECASTS OPPOSITE PROFILE), DUE TO TIMING OF DEBLOCKING OF SAVINGS ACCOUNTS AND TO 10 PER- CENT RISE IN PENSION PAYMENTS DUE AT MID-YEAR.

6. SIMILARITY OF SECRETARIAT AND FRG FORECASTS OF GROWTH OF FIXED CAPITAL FORMATION WAS COINCIDENTAL (SECRETARIAT PROJECTS INCREASE OF 4.5 PERCENT; FRG, 5 PERCENT) AS SIG- NIFICANT DIFFERENCES EXISTED CONCERNING PROSPECTS FOR COM- PONENTS OF THIS AGGREGATE. MAJOR DIVERGENCE LAY IN OUT- LOOK FOR RESIDENTIAL CONSTRUCTION WITH SECRETARIAT FORE- CASTING STAGNATION, AND FRG, A RISE OF 3.5 PERCENT. GER- MANS STATED THAT SELECTIVE POLICIES TO SUPPORT CONSTRUC- TION SECTOR WOULD HELP KEEP SPENDING UP, BUT DEFENDED THEIR FORECAST MAINLY ON GROUNDS THAT SECRETARIAT HAD IGNORED SUBSTANTIAL SPENDING ON RESTORATION OF OLD BUILD- INGS.

7. STRESSING SUCCESS ACHIEVED IN UNWINDING INFLATIONARY EXPECTATIONS, FRG DELS NOTED THAT RESULTING DECLINE IN LONG-TERM INTEREST RATES WOULD HAVE FAVORABLE EFFECT ON BUSINESS INVESTMENT. THEY DISMISSED SECRETARIAT CONTEN- TION THAT EXISTENCE OF EXCESS CAPACITY WOULD CONSTITUTE DRAG ON INVESTMENT SPENDING AND ARGUED THAT (A) DEGREE OF EXCESS CAPACITY VARIES CONSIDERABLY AMONG SECTORS (E.G., AUTOMOBILE SECTOR IS OPERATING AT FULL CAPACITY); AND (B) CAPACITY UTILIZATION RATE NOT PRIMARY DETERMINANT OF INVESTMENT SPENDING IN GERMANY; RATE OF RETURN ON INVEST- MENT IS CONTROLLING INFLUENCE. REFERRING TO POINT (B), FRG STRESSED NEED TO EFFECT FURTHER REDUCTIONS IN SHARE LIMITED OFFICIAL USE

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OF WAGES IN VALUE-ADDED AND SAID THAT PRESENT RATE OF RETURN ON CAPITAL WAS BELOW 10 PERCENT FIGURE ESTIMATED BY SECRETARIAT AND BELOW LONG-TERM INTEREST RATE.

8. UNEMPLOYMENT: FRG AND SECRETARIAT PUT TOTAL NUMBER OF UNEMPLOYED AT 1 MILLION; FRG DELS CHARACTERIZED THIS SITUATION AS POLITICALLY UNSUSTAINABLE AND STATED INTEN- TION OF REDUCING UNEMPLOYMENT BY 225,000 BY MID-1978 THROUGH SELECTIVE MANPOWER MEASURES AS WELL AS THROUGH OTHER PROGRAMS, SUCH AS SUPPORT OF CONSTRUCTION SECTOR. WHILE COMMENTING THAT SECRETARIAT'S ANALYSIS SEPARATING

UNEMPLOYMENT INTO "STRUCTURAL," "CYCLICAL" AND "MEDIUM-TERM" COMPONENTS (SEE PARA 5, REF C) WAS SUBJECT TO WIDE MARGINS OF ERROR, GERMANS DID NOT TAKE SERIOUS ISSUE WITH THIS ANALYSIS. THEY DID, HOWEVER, OBJECT STRONGLY TO SECRETARIAT'S RECOMMENDATION THAT FRG ATTEMPT TO COMBINE REDUCTION IN MEDIUM-TERM UNEMPLOYMENT WITH CONTINUED PRICE STABILITY, IN FRAMEWORK OF "CONCERTED ACTION PROGRAM," BY UNDERTAKING COMMITMENT TO EXPANSION OF DEMAND IN RETURN FOR RESPECTIVE COMMITMENTS BY LABOR AND BUSINESS TO MODERATE WAGE AND PRICE BEHAVIOR. IN FRG VIEW, LABOR WOULD VIEW SUCH A GOVERNMENT INITIATIVE AS AN UNACCEPTABLE INTERFERENCE IN PROCESS OF FREE COLLECTIVE BARGAINING.

9. OUTLOOK FOR 1978: WHILE STATING FRG HAS NOT YET

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FORMULATED DETAILED FORECASTS FOR 1978, GERMAN DEL FELT IT HIGHLY UNLIKELY THAT DECELERATION OF GNP GROWTH FORECAST BY SECRETARIAT FOR FIRST HALF OF NEXT YEAR WOULD MATERIALIZE. MAJOR UNCERTAINTY CONCERNED FINAL SHAPE OF TAX/EXPENDITURE PACKAGE FRG PLANS TO IMPLEMENT ON JANUARY 1, 1978. GERMANS INDICATED THAT LATEST GOVERNMENT PROPOSAL, WHICH CONTAINS 1 PERCENT INCREASE IN VAT RATE

(VS. 2 PERCENT PROPOSED INITIALLY) WOULD RESULT IN NET REVENUE LOSS OF 1 BILLION DM, IN CONTRAST TO NET REVENUE INCREASE OF 4 BILLION DM UNDER INITIAL PROPOSAL. THEY STATED THAT WHATEVER THE SPECIFIC NATURE OF THE TAX/EXPENDITURE PACKAGE, IT WAS LIKELY THAT ANY FURTHER CHANGES WOULD BE IN DIRECTION OF INCREASING GOVERNMENT DEFICIT.

L0. FRG DEL ACKNOWLEDGED THAT GROWTH OF PRIVATE CONSUMPTION WOULD PROBABLY DECELERATE IN FIRST HALF OF NEXT YEAR, BUT FELT THAT INCREASES IN EMPLOYMENT AND IN WAGES WOULD PREVENT A DECELERATION AS MARKED AS THAT FORECAST LIMITED OFFICIAL USE

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BY SECRETARIAT (#2 PERCENT AT ANNUAL RATE VS. #3-3/4 PERCENT IN LATTER HALF OF 1977). IN ADDITION, FRG EXPECTS SPEEDING UP IN RESIDENTIAL CONSTRUCTION ACTIVITY, WHEREAS SECRETARIAT FORECASTS CONTINUED DECLINE. FINALLY, GERMANS EMPHASIZED THAT DEMAND IMPACT OF SPENDING IN 1977 UNDER MEDIUM-TERM INVESTMENT PROGRAM WOULD BE FELT PRIMARILY IN 1978. SECRETARIAT ADMITTED THAT SOME UPWARD REVISION OF ITS GROWTH FORECAST FOR FIRST HALF OF 1978 MIGHT BE IN ORDER. NEITHER SECRETARIAT NOR FRG EXPECTED INFLATION TO ACCELERATE IN 1977 OR IN 1978.

11. CURRENT ACCOUNT: U.S. NOTED THAT FRG CURRENT ACCOUNT SURPLUS REGISTERED IN FIRST QUARTER OF 1977 (\$732 MILLION, SEASONALLY ADJUSTED) IMPLIED THAT SECRETARIAT (AND FRG) FORECAST OF \$1.5 BILLION FOR YEAR COULD WELL BE TOO LOW. SECRETARIAT REPLIED THAT UPWARD REVISION OF ITS FORECAST MIGHT BE APPROPRIATE. FRG DELS EMPHASIZED THAT STRONG JANUARY-APRIL SURPLUS RESULTED PRIMARILY FROM DECLINE IN OIL IMPORTS WHILE EXPORTS TO OECD COUNTRIES AND TO NON-OIL LDC'S WERE RISING LESS RAPIDLY THAN FRG IMPORTS FROM THESE COUNTRIES. GERMANS CONCLUDED THAT FRG WAS DOING ITS PART TO ASSIST BALANCE OF PAYMENTS ADJUSTMENT PROCESS. LESS THAN SATISFIED WITH FRG RESPONSE, SECRETARIAT COMMENTED FORCEFULLY THAT FRG SHOULD ACT (E.G., WITH FISCAL STIMULUS) TO ELIMINATE DEFICIT BY SHIFTING PATTERN OF DEMAND SUCH THAT GROWTH OF DOMESTIC DEMAND WOULD EXCEED THAT OF GNP. SECRETARIAT SUGGESTED APPROPRIATE GROWTH RATE OF DOMESTIC DEMAND WOULD BE IN VICINITY OF 6 PERCENT. U.S. REMARKED THAT MORE RAPID EXPANSION OF DOMESTIC DEMAND MIGHT BE DESIRABLE TO ABSORB INCREASED SLACK RESULTING FROM APPRECIATION OF DM. FRG STATED THAT IT WAS FULLY PREPARED TO SEE CURRENT ACCOUNT MOVE INTO DEFICIT, BUT GENERALLY ARGUED AGAINST APPLICATION OF FISCAL STIMULUS (SEE PARA 12, BELOW).

12. FISCAL AND MONETARY POLICY; FISCAL POLICY: U.S.

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POINTED TO GROWING RISK THAT GNP GROWTH IN 1977 WOULD FALL SHORT OF TARGET (5 PERCENT) TO WHICH FRG HAD COMMITTED ITSELF AT SUMMIT. WHILE NOTING THAT TIME WAS RAPIDLY RUNNING OUT FOR POLICY MEASURES TO AFFECT GROWTH OUTCOME FOR THIS YEAR, U.S. SOLICITED GERMAN VIEWS CONCERNING WHAT ADDITIONAL ACTION THEY MIGHT BE PREPARED TO TAKE IF GROWTH AND UNEMPLOYMENT DEVELOPMENTS IN BALANCE OF 1977 AND IN FIRST HALF OF 1978 PROVED TO BE WEAKER THAN FRG PRESENTLY EXPECTS. OTHER DELS ECHOED U.S. VIEW AND ALSO COMPLAINED THAT FRG PERFORMANCE WAS SUBSTANDARD IN TERMS OF ILLUSTRATIVE GROWTH PATHS SET OUT IN OECD MEDIUM-TERM STRATEGY ENDORSED AT JUNE, 1976 OECD MINISTERIAL. FRG (WITH SUPPORT FROM AUSTRALIANS) DENIED DESIRABILITY, APPROPRIATENESS AND EFFICACY OF ADDITIONAL FISCAL STIMULUS. THEY REITERATED THEIR NOW-FAMILIAR POLICY THEOLOGY THAT MORE STIMULUS WOULD AWAKEN INFLATIONARY EXPECTATIONS AND SHAKE PRIVATE SECTOR CONFIDENCE, THEREBY LEADING TO OFFSETTING REDUCTION IN PRIVATE SPENDING PROPENSITY AND TO ACCELERATION OF INFLATION. FRG FURTHER ASSERTED THAT INCREASE IN BUDGET DEFICIT WOULD (A) HAVE "CROWDING OUT" EFFECT ON PRIVATE INVESTMENT AND (B) BE PREJUDICIAL TO OFFICIAL OBJECTIVE OF REDUCING PUBLIC FINANCING DEFICIT TO 2 PERCENT OF GNP BY 1980 (I.E., TO 30 BILLION DM COMPARED WITH DEFICIT OF 39 BILLION DM FORECAST FOR 1977, OR 3.1 PERCENT OF FORECAST 1977 GNP). FINALLY, FRG ARGUED THAT SEVERAL SELECTIVE MEASURES TO

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REDUCE UNEMPLOYMENT AND/OR TO CORRECT REGIONAL AND SECTORAL IMBALANCES HAD RECENTLY BEEN INITIATED (OR EXTENDED) IN A MEDIUM-TERM CONTEXT AND WOULD PROVIDE SUFFICIENT SUPPORT TO GROWTH. SECRETARIAT AND FRG CAME TO "MEXICAN STANDOFF" ON QUESTION OF NEED FOR FISCAL STIMULUS IN PRESENT SITUATION AND ON ROLE OF COUNTERCYCLICAL FISCAL POLICY IN GENERAL.

13. MONETARY POLICY: FRG DELS SAID THAT TARGET OF 8 PERCENT FOR GROWTH OF CENTRAL BANK MONEY STOCK (CMB) IN 1977 WAS SET SO AS TO LUBRICATE EXPANSION WHILE CONTAINING INFLATION. THEY NOTED THAT WHILE CBM GREW BY ONLY 4 PERCENT IN FIRST FOUR MONTHS OF THIS YEAR, TEMPORARY SLOW GROWTH WAS AN APPROPRIATE REACTION TO OVERHANG OF LIQUIDITY AT END OF 1976. MOREOVER, GERMANS INDICATED THAT THEY WOULD TAKE ACTION, AS APPROPRIATE, TO AVOID UPWARD PRESURE ON INTEREST RATES (E.G., 5 BILLION DM WERE FUNNELED TO LANDER BANKS ON MAY 1 TO OFFSET SEASONAL LIQUIDITY SHORTAGE).

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14. CLEAR VIEW OF EDRC WAS THAT, AT CURRENT JUNCTURE, FRG ECONOMY COULD USE AN "UPPER;" GERMAN DEL JUST AS CLEARLY WAS IN NO MOOD TO TAKE SUCH PRESCRIPTION.

15. QUESTIONS RAISED REF B, PARAS 2, 3, 4 AND 5 ADDRESSED PARAS 12, 13, 6, 7 AND 5. CONCERNING ADDITIONAL POINT RAISED REF B, PARA 3, FRG FEELS THAT REDUCTION IN WORK WEEK WOULD BE ACCOMPANIED BY INDUCED PRODUCTIVITY INCREASES. THUS, THEY CONSIDER EMPLOYMENT EFFECT OF REDUCING WORK WEEK BY ONE HOUR WOULD BE LESS THAN 600,000, CALCULATED BY EXPERTS GROUP.

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